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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**Date Issued:** November 19, 2009

**IBA Report Number:** 09-88

**City Council Meeting Date:** November 23, 2009

**Item Number:** S401

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# FY 2010 First Quarter Budget Monitoring Report

## OVERVIEW

On November 17, 2009, the Financial Management Department issued the Fiscal Year 2010 First Quarter Budget Monitoring Report, which presents projections of year-end revenues and expenditures, based on actual data for the first three months of the fiscal year (through September 30, 2009).

The IBA has reviewed the FY 2010 First Quarter Budget Monitoring Report, comparing information to the Comptroller's recent Financial Performance Report, and the Mayor's updated Five-Year Financial Outlook. No budget adjustments are recommended as part of the FY 2010 First Quarter Budget Monitoring Report, primarily because the net projected budgetary deficit of \$7.5 million for FY 2010 is not considered to be significant this early in the year. Changes to projections will occur throughout the fiscal year.

Additionally, early next week, the Mayor will be issuing budgetary reduction proposals for Council review and approval, which are intended to address the projected FY 2011 budgetary gap. Some of these reductions are expected to be enacted this fiscal year, which will also alter the current projected budgetary status for FY 2010.

## FISCAL/POLICY DISCUSSION

The following chart summarizes the FY 2010 Adopted Budget and First Quarter Projections, along with actual revenue and expenditure activity for FY 2009. This summary reflects the significant year-to-year change in projected revenues and expenditures. Based on the First Quarter Projection, General Fund revenues are now projected to be approximately \$44 million less than prior year, which is a 3.9 percent

decline. General Fund expenditures are currently projected to be \$18.2 million less than last year, or 1.6 percent lower. The projected \$39 million deficit is caused, in part, by the inclusion of expenditures related to prior year commitments, which had previously been accounted for separately.

General Fund Status Fiscal Year 2010 (in millions)					
	FY 2009 Unaudited Actuals*	FY 2010 Adopted Budget	FY 2010 First Quarter Projection	FY 2010 Budget Variance	Projection Change from FY 2009
Revenues	\$1,123.3	\$1,129.7	\$1,079.3	<b>(\$50.4)</b>	<b>(\$44.0)</b>
Expenditures	1,136.5	1,129.7	1,118.3	<b>11.4</b>	<b>(18.2)</b>
Net Balance	(\$13.2)	--	(\$39.0)	<b>(\$39.0)</b>	<b>(\$25.8)</b>

\*FY 2009 Unaudited Actual Expenditures include \$27.4 million in encumbrances

### Prior Year Encumbrances

A change in procedure regarding the treatment of prior year encumbrances (amounts legally obligated to be spent in the future) was addressed in the City Budget Policy and has been implemented in the First Quarter Report.

The City of San Diego has historically used prior year budgets as a means to preserve appropriations for encumbered commitments that are in place at the end of a fiscal year. But beginning with Fiscal Year 2010, the practice of carrying forward appropriations associated with these encumbered commitments will be discontinued for all General Fund Departments (the procedure will be fully implemented for non-general funds in FY 2011). This policy change is expected to improve the transparency of the City's financial reporting as well as assist in budgetary control.

Departments were instructed to include expenditures associated with commitments that continued from Fiscal Year 2009 (and prior years) in their projections. This means that expenditures are being accounted for in FY 2010 for which there are prior year appropriations but not current year budget. As a result, several departments are projected to exceed their budgets.

For the past few fiscal years, our office has recommended additional review, monitoring and reporting of the funds carried over each year to ensure those commitments continued to be of the highest priority to the City, given changing financial circumstances.

The IBA supports the new policy regarding prior year encumbrances but also recognizes potential issues that may arise. Since FY 2010 is a transition year, departments will have the opportunity to close unneeded encumbrances to reduce the impact of this change. However, encumbered funds that are still necessary for future projects will no longer be available. It is intended that, at year-end, departments, if needed, will have the

opportunity to request additional funding in their FY 2011 budget for these specific purposes (which will require City Council approval). However, this will be subsequent to the City's reductions in FY 2010 taking place and continuing to impact FY 2011. Therefore, granting these requests will be difficult as additional funding will have to be identified. Aside from this concern, the IBA supports this change in the treatment of encumbrances related to the budget.

The procedural change allows the release of prior year appropriations of \$31.5 million to mitigate the projected \$39 million deficit, resulting in a net budgetary deficit of \$7.5 million.

General Fund Mitigation	
Release of Prior Year Appropriations	\$31.5 million
Net Balance FY 2010	(39.0 million)
Net Budgetary Deficit	(\$7.5 million)

**General Fund Allocated Reserve**

Separate from prior year encumbrances, there also exists a General Fund Allocated Reserve, which is used to carry forward funds for specific projects as authorized by the City Council. At present, the Allocated Reserve totals \$634,869, and includes three items as shown in the table to the right.

General Fund Allocated Reserve	
Title	Amount
Auditor Financial Reporting	\$34,360
Shell Beach and Stair Repair	\$200,000
City Planning – CP Updates	\$400,000

Funding for some of these items has been authorized since Fiscal Year 2006. As City management revisits its procedures for prior year encumbrances, the IBA suggests funding within the Allocated Reserve be reviewed and released to the General Fund, and that consideration be given to discontinue the use of the Allocated Reserve. The Allocated Reserve is not specifically described in the City's Reserve Policy, is not intended to serve as a reserve for general purposes, and is not included in the City's calculations in determining or monitoring reserve levels. Discontinuing the Allocated Reserve would not impact either the Appropriated Reserve or Unallocated Reserve, both of which would remain in place, per the City's Reserve Policy.

**Potential Use of Reserves**

The First Quarter Report describes a current projected year-end deficit of \$7.5 million, and shows a scenario (Table 2) reflecting the impact to the General Fund Reserve if reserves need to be drawn upon to balance the General Fund at year-end. Under this scenario, the General Fund Reserve would be reduced by \$7.5 million to \$70 million, and would be \$5.6 million short of the 7 percent goal (of \$75.6 million), as currently defined in the City's Reserve Policy. The reserve goal is calculated as 7 percent of total General Fund revenues for FY 2010, and will increase to 7.5 percent in FY 2011.

As defined in the City's Reserve Policy, use of the reserves is a policy decision requiring City Council approval. While no action to use the reserves is requested at this time, it is important to note that such a request may be considered, and could be forthcoming prior

to the end of the fiscal year. Alternatively, as noted earlier, it is quite possible that other budget changes or proposals may mitigate the FY 2010 budgetary deficit which could eliminate the need for the use of reserve funds.

### General Fund Revenue

The Comptroller's Financial Performance Report (as of September 30, 2009) shows that General Fund revenue receipts to-date comprise 6 percent of budget estimates.

During FY 2009, 7.9 percent of total actual revenues were received by this same time.

As is typical at this point in the fiscal year, the City awaits receipt of over 90% of its General Fund revenues, during a time when the economy continues to decline. Some revenue sources are susceptible to current economic conditions and factors, while others may not be immediately affected.

The Mayor's updated Five-Year Financial Outlook projected a \$21.7 million reduction in General Fund revenues from the FY 2010 Adopted Budget. The \$21.7 million reduction was particularly related to declining performance in sales tax and transient occupancy tax due to the recession. In consideration of current revenue performance and economic information, the First Quarter Report projects an additional decline of \$28.7 million from the Outlook, for a total reduction of \$50.4 million in General Fund revenues over budget. Of this additional decline, \$11.0 million is related to revised projections for major revenues and \$17.7 million is related to reductions in departmental revenue.

In general, the IBA assesses that the First Quarter Report revenue projections are in line with economic forecasts and current receipt trends. Any change in economic assumptions and receipt trends would compel a revision in the revenue forecast at a future time. This remains a risk as the state of the economy remains volatile. Recent economic data has shown national signs of a recovery from the recession with estimated 3<sup>rd</sup> quarter GDP annual growth of 3.5%, while during the same period, San Diego County mortgage notices of default were up by 23.2% as compared to the 3<sup>rd</sup> quarter of 2008 per Dataquick. High unemployment, low personal income growth, increased savings, and a tightened credit market will continue to negatively impact economically sensitive revenues such as property tax, sales tax, and TOT.

The chart below summarizes the Outlook FY 2010 projections and the revisions presented in the First Quarter Report.

General Fund Revenue (in millions)

GF Revenue (in millions)	FY 2009 Actuals <sup>1</sup>	FY 2010 Budget	FY 2010 Outlook Projection	Over Budget/ (Under Budget)	FY 2010 1st Quarter Projection	Over Budget/ (Under Budget)
Property Tax	\$ 398.7	\$ 382.6	\$ 391.6	\$ 9.0	\$ 392.7	\$ 10.1
Sales Tax	\$ 206.1	\$ 210.1	\$ 185.4	\$ (24.7)	\$ 184.4	\$ (25.7)
TOT	\$ 74.2	\$ 75.9	\$ 71.2	\$ (4.7)	\$ 66.8	\$ (9.1)
Franchise Fees	\$ 65.1	\$ 73.7	\$ 73.7	\$ -	\$ 70.2	\$ (3.5)
Other Revenue	\$ 379.2	\$ 387.4	\$ 386.1	\$ (1.3)	\$ 365.2	\$ (22.2)
<b>Total GF</b>	<b>\$ 1,123.3</b>	<b>\$ 1,129.7</b>	<b>\$ 1,108.0</b>	<b>\$ (21.7)</b>	<b>\$ 1,079.3</b>	<b>\$ (50.4)</b>
<i>Growth Over FY 09</i>	-	0.6%	-1.4%		-3.9%	

1. Unaudited actual

*Possible Impact of Revenue Projections on FY 2011*

The First Quarter Report revenue projections do not bode well for the Five-Year Outlook. The FY 2010 baseline, as projected in the First Quarter Report, is lower than originally projected in the Five-Year Outlook. In using the current FY 2010 projections as a baseline for the Five-Year Outlook, and keeping constant all Outlook revenue and expenditure growth assumptions, the FY 2011 deficit increases by \$26.7 million in FY 2011, \$27.5 in FY 2012, \$28.0 million in FY 2013, \$28.4 million in FY 2014, and \$28.8 million in FY 2015. Financial Management staff is currently evaluating FY 2011 growth rate assumptions, as presented in the Outlook, for possible revisions based on new economic and performance data. These revisions, and their impact on the projected FY 2011 deficit, will be released as part of the Mayor's Report of Recommended Budget Reductions for FY 2011.

Scenario	FY 2011 Forecast	FY 2012 Forecast	FY 2013 Forecast	FY 2014 Forecast	FY 2015 Forecast
Mayor's Outlook	\$ 1,061.6	\$ 1,094.1	\$ 1,125.4	\$ 1,156.8	\$ 1,196.6
Impact of Current Projections	\$ 1,034.9	\$ 1,066.6	\$ 1,097.4	\$ 1,128.4	\$ 1,167.8
Difference	\$ (26.7)	\$ (27.5)	\$ (28.0)	\$ (28.4)	\$ (28.8)

**General Fund Expenditures**

At this time last year, the IBA had recommended that immediate expenditure restrictions be put into place to generate savings and contain costs, in order to balance the City's General Fund. Recommendations included placing a freeze on travel and training, equipment outlay purchases, and overtime authorizations. Also, our office recommended that work begin on reviewing and prioritizing contractual services, evaluating program

reductions, consideration of furlough periods, and updates to user fees. Most of these recommendations were incorporated into the FY 2010 budget.

The First Quarter Report describes projected net General Fund savings of \$11.4 million. Areas of predominant savings include the expenditure categories of Salaries and Wages (\$11.5 million) and Fringe Benefits (\$10.1 million), largely attributable to the significant number of vacancies. These savings are offset somewhat by projected overspending in the Contracts category (\$13.2 million) due to the inclusion of expenditure projections related to prior year commitments/encumbrances, as described earlier.

#### *Public Safety Departments*

In IBA Report [09-75](#), the IBA estimated that Police Department vacancy savings for sworn staff would result in salary and fringe savings totaling approximately \$19.0 million above the department's budgeted \$20.7 million vacancy factor. This estimate was based on department vacancy data during the month of September, and assumed that all sworn vacancies would remain unfilled. Given that a police academy was underway at the time of the implementation of a citywide hiring freeze in September, a 40 recruit academy was authorized to start in the month of October as scheduled. With the authorization of the October academy, the department's current projected salary and fringe savings of \$15.5 million, as shown in the First Quarter Report, is lower than original IBA estimates because of the changed circumstances.

The Fire-Rescue Department was also authorized to continue a scheduled 35 recruit academy. The IBA's original salary and fringe savings estimates for Fire-Rescue accounted for this academy given that it was already ongoing at the time of the implementation of the citywide hiring freeze. With this, Fire-Rescue Department's projection of negligible salary and fringe savings concurs with a similar IBA estimate in IBA Report [09-75](#).

As for future police and firefighter academies, they are cancelled until further notice. Continuing this policy captures \$15.5 million in savings in the current fiscal year, as reflected in the First Quarter Report.

## CONCLUSION

In summary, this report highlights significant areas related to the First Quarter Financial Monitoring Report. The IBA compared the First Quarter Report to the Comptroller's recent Financial Performance Report, and the Mayor's updated Five-Year Financial Outlook.

It is important to note that no action of the Council is currently requested. No budget adjustments are recommended at this time, primarily because the net projected budgetary

deficit of \$7.5 million for FY 2010 is not considered to be significant this early in the year, and the Mayor will very soon be issuing budgetary reduction proposals for Council review and approval, which are expected to address FY 2010 and FY 2011.

Changes to the procedures related to prior year encumbrances have been incorporated in the projections, and assist with mitigating the General Fund budgetary deficit. Ongoing procedural changes in this area could impact departments' abilities to adequately fund projects that continue into next fiscal year. Aside from this concern, our office supports these changes towards a more transparent approach to treating encumbrances.

The IBA concurs with revised revenue and expenditure projections for the current year, and has identified potential impacts to the updated Five-Year Financial Outlook if revised FY 2010 revenue projections are applied to the Outlook period. However, additional review and analysis in the revenue area is planned in the weeks ahead as budget reduction proposals are presented. The revisions to expenditure projections as reflected in the First Quarter Report are consistent with recently changed circumstances.

**[SIGNED]**

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